Michigan Department of Treasury
496 (02/06)

Auditing Procedures Report

Issued under P.A. 2 of 1968, as amended and P.A. 71 of 1919, as amended.

Local Unit of Government Type	Local Unit Name	County
☐County ☐City ☐Twp ☐Village ☒Other	Petoskey Hospital Finance Authority	Emmet

Fiscal Year End	Opinion Date	Date Audit Report Submitted to State
June 30, 2007	December 28, 2007	January 15, 2008

We affirm that:

We are certified public accountants licensed to practice in Michigan.

We further affirm the following material, "no" responses have been disclosed in the financial statements, including the notes, or in the Management Letter (report of comments and recommendations).

	YES	NO	**Check each applicable box below.** (See instructions for further detail.)
1.	☒	☐	All required component units/funds/agencies of the local unit are included in the financial statements and/or disclosed in the reporting entity notes to the financial statements as necessary.
2.	☒	☐	There are no accumulated deficits in one or more of this unit's unreserved fund balances/unrestricted net assets (P.A. 275 of 1980) or the local unit has not exceeded its budget for expenditures.
3.	☒	☐	The local unit is in compliance with the Uniform Chart of Accounts issued by the Department of Treasury.
4.	☒	☐	The local unit has adopted a budget for all required funds.
5.	☒	☐	A public hearing on the budget was held in accordance with State statute.
6.	☒	☐	The local unit has not violated the Municipal Finance Act, an order issued under the Emergency Municipal Loan Act, or other guidance as issued by the Local Audit and Finance Division.
7.	☒	☐	The local unit has not been delinquent in distributing tax revenues that were collected for another taxing unit.
8.	☒	☐	The local unit only holds deposits/investments that comply with statutory requirements.
9.	☒	☐	The local unit has no illegal or unauthorized expenditures that came to our attention as defined in the *Bulletin for Audits of Local Units of Government in Michigan*, as revised (see Appendix H of Bulletin).
10.	☒	☐	There are no indications of defalcation, fraud or embezzlement, which came to our attention during the course of our audit that have not been previously communicated to the Local Audit and Finance Division (LAFD). If there is such activity that has not been communicated, please submit a separate report under separate cover.
11.	☒	☐	The local unit is free of repeated comments from previous years.
12.	☒	☐	The audit opinion is UNQUALIFIED.
13.	☒	☐	The local unit has complied with GASB 34 or GASB 34 as modified by MCGAA Statement #7 and other generally accepted accounting principles (GAAP).
14.	☒	☐	The board or council approves all invoices prior to payment as required by charter or statute.
15.	☒	☐	To our knowledge, bank reconciliations that were reviewed were performed timely.

If a local unit of government (authorities and commissions included) is operating within the boundaries of the audited entity and is not included in this or any other audit report, nor do they obtain a stand-alone audit, please enclose the name(s), address(es), and a description(s) of the authority and/or commission.

I, the undersigned, certify that this statement is complete and accurate in all respects.

We have enclosed the following:	Enclosed	Not Required (enter a brief justification)
Financial Statements	☒	
The letter of Comments and Recommendations	☐	Conduit entity with timely bond payments.
Other (Describe)	☐	

Certified Public Accountant (Firm Name)	Telephone Number		
Hill, Schroderus & Co., LLP	231-347-4136		
Street Address	**City**	**State**	**Zip**
923 Spring Street	Petoskey	MI	49770
Authorizing CPA Signature	**Printed Name**	**License Number**	
James Cusenza	James Cusenza	1101012888	

FINANCIAL REPORT
PETOSKEY HOSPITAL FINANCE AUTHORITY
EMMET COUNTY
Year Ended June 30, 2007

PETOSKEY HOSPITAL FINANCE AUTHORITY
FINANCIAL REPORT
Year Ended June 30, 2007

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Hill • Schroderus & Co., LLP
Certified Public Accountants & Consultants

December 28, 2007

Independent Auditors' Report

Board of Commissioners
Petoskey Hospital Finance Authority
Emmet County, Michigan

We have audited the accompanying financial statements of the Petoskey Hospital Finance Authority, Emmet County, Michigan, as of and for the year ended June 30, 2007, as listed in the table of contents. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Petoskey Hospital Finance Authority, Emmet County, Michigan, as of June 30, 2007, and the changes in financial position and cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

The Authority has not presented management's discussion and analysis that accounting principles generally accepted in the United States of America has determined is necessary to supplement, although not required to be part of the basic financial statements.

Hill Schroderus & Co.

CERTIFIED PUBLIC ACCOUNTANTS
Petoskey, Michigan

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PETOSKEY HOSPITAL FINANCE AUTHORITY
STATEMENT OF NET ASSETS
June 30, 2007

Assets		
Current assets:		
Cash - restricted for Sinking Fund use	$	1,083
Current portion of loan receivable from Northern Michigan Hospital, Inc. (Hospital)		2,164,354
Loan receivable from Hospital (net of current portion and unearned discounts and charges)		46,996,636
Deferred charges - debt issue costs		502,368
Total assets	$	49,664,441
Liabilities and Net Assets		
Liabilities:		
Current portion of bonds payable	$	2,164,354
Bonds payable (net of current portion, unamortized original issue discount and unamortized refunding deferral)		47,500,087
Total liabilities		49,664,441
Net assets restricted for debt service		-
Total liabilities and net assets	$	49,664,441

See accompanying notes to financial statements.

PETOSKEY HOSPITAL FINANCE AUTHORITY
STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
Year Ended June 30, 2007

Revenues:	
Payments received from Hospital to defray Series 1998 Bond interest expense	$ 1,602,700
Payments made by Hospital to defray Series 2003 and Series 2006 Bond interest expense	727,213
Recognition of deferred revenue as revenue for current amortization of bond original issue discount, bond issue costs and refunding deferral, adjusting amounts actually due from Hospital to defray interest expense	170,489
Total revenues	2,500,402
Expenses:	
Interest expense	2,500,402
Excess (deficiency) of revenues over expenses	-
Net assets, beginning	-
Net assets, ending	$ -

See accompanying notes to financial statements.

PETOSKEY HOSPITAL FINANCE AUTHORITY
STATEMENT OF CASH FLOWS
Year Ended June 30, 2007

Cash flows from operating activities:		
Cash received from Hospital		$ 2,722,700
Cash flows from capital financing activities:		
Cash received from escrow account		1,083
Principal paid on bonds		(1,120,000)
Interest paid on bonds		(1,602,700)
Net cash provided (used) for capital financing activities		(2,721,617)
Net increase (decrease) in cash and cash equivalents		1,083
Cash and cash equivalents, beginning		-
Cash and cash equivalents, ending		$ 1,083
Reconciliation of excess (deficiency) of revenues over expenses to net cash provided by operating activities:		
Excess (deficiency) of revenues over expenses		$ -
Adjustments to reconcile excess (deficiency) of revenues over expenses to net cash provided by operating income:		
Amortization of deferred revenue	(170,489)	
Interest expense	2,500,402	
Non-cash operating revenue (expenses)	(727,213)	
Payments received for non-operating purposes	1,120,000	
Total adjustments		2,722,700
Net cash provided by operating activities		$ 2,722,700

Noncash capital financing activities - During the year ended June 30, 2007, the $10,000,000 proceeds of the Series 2006 Bonds were deposited directly into an escrow account for the Hospital to use to buy equipment. Additionally, the Hospital made principal payments on the 2003 Series Bonds in the amount of $289,821 as well as interest payments on both the 2003 and 2006 Series Bonds in the amount of $727,213.

See accompanying notes to financial statements.

The Petoskey Hospital Finance Authority (the Authority), a governmental finance authority, was created as a corporate instrumentality in 1977 by the City of Petoskey under the provisions of the Hospital Finance Authority Act, Act 38, Public Acts of Michigan, 1969, as amended. The Authority was incorporated for the purpose of acquiring, constructing, remodeling, enlarging, repairing, owning and leasing health care facilities. It was also incorporated to finance or refinance these activities and to lend money to a hospital for similar purposes.

In prior years, the Authority constructed a new hospital facility and renovated existing hospitals for Northern Michigan Hospital, Inc. of Petoskey, Michigan (the Hospital). The Authority issued bonds to finance those projects and then leased the facilities to the Hospital. During fiscal 1990, additional bonds were issued which permitted expansion and refinancing of the project. Under the refinancing, a portion of the prior bonds were retired and the balance defeased. The facilities were sold to Northern Michigan Hospital, Inc. and the Hospital agreed to repay the Authority for monies the Authority had expended on behalf of the Hospital and amounts loaned to the Hospital for additional expansion.

In December, 1995, the Authority issued a revenue bond for the purpose of making a loan to the Hospital to be used to acquire, construct, renovate and equip hospital facilities pursuant to a Hospital Loan Agreement between the Hospital and the Authority.

In February, 1998, the Authority issued limited obligation revenue and refunding bonds. The bonds were issued to provide funds to be loaned by the Authority to the Hospital to be used, together with other available funds to (i) advance refund the Authority's Hospital Revenue and Refunding Bonds, Series 1989 , (ii) current refund the Authority's Hospital Revenue Bond Series 1995, (iii) pay a portion of the costs of the project commenced in 1995 to acquire, construct, renovate and equip hospital facilities pursuant to a loan agreement between the Hospital and Authority and (iv) pay the costs of issuing the Bonds.

In October, 2003, the Authority issued limited obligation revenue bonds. The bonds were issued for the purpose of funding a loan by the Authority to the Hospital for the purpose of financing all or a portion of the cost of acquiring, constructing and equipping certain hospital facilities located in the City of Petoskey, Michigan and the payment of necessary costs incidental thereto.

In December, 2006, the Authority issued a limited obligation lease revenue bond. The bond was issued for the purpose of making funds available for the benefit of the Hospital for the purpose of financing all or a portion of the cost of equipment to be used in connection with the Hospital's health care operations.

NOTE 1: ACCOUNTING POLICIES

The financial statements of the Authority have been prepared on the accrual basis of accounting except for the recognition of interest income and expense as explained below. The Governmental Accounting Standards Board (GASB) is the standard-setting body for governmental accounting and financial reporting. The Authority's reporting entity applies all relevant Governmental Accounting Standards Board (GASB) pronouncements. The proprietary fund applies Financial Accounting Standards Board (FASB) pronouncements and Accounting Principles Board (APB) opinions issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements, in which case, GASB prevails. Pronouncements of the FASB issued after November 30, 1989 are not applied in the preparation of the financial statements of the proprietary fund in accordance with GASB Statement No. 20.

NOTE 1: ACCOUNTING POLICIES – CONTINUED

Accounting policies for specific items follow:

Loan receivable is carried at face value net of unearned discounts and charges.

Unearned discounts and charges is the difference between the face value of the loan receivable from the Hospital and the related bonds payable net of unamortized debt issue costs, original issue discount and refunding deferral. As interest expense is recognized for amortization of these items so is a corresponding amount of revenue recognized for amounts not due from the Hospital to defray this interest expense.

Outstanding bonds not defeased are recorded as a liability.

Deferred charges – debt issue costs of $849,674 and $110,249 are being amortized as interest expense using the interest method over the life of the Series 1998 and 2003 bonds, respectively. Interest expense of $48,732 was recognized in the current year; unamortized amounts at year-end amounted to $502,368.

Original issue discounts of $597,467 are being amortized as interest expense using the interest method over the life of the Series 1998 bonds. Interest expense of $28,464 was recognized in the current year; unamortized amounts at year-end amounted to $297,483.

Refunding deferral (the difference between the requisition price and the net carrying amount of the Series 1989 bonds advance refunded) of $2,039,539 is being amortized as interest expense on a straight-line basis over the original remaining life of the 1989 Series bonds. Interest expense of $93,294 was recognized during the year. The unamortized balance at year-end was $1,166,154.

Interest expense associated with the bonds is recorded when cash is disbursed. Accruing interest expense would be offset by accrued revenue from the Hospital resulting in essentially the same position and results of operations.

For purposes of the Statement of Cash Flows, cash is considered to be cash on hand and demand deposits.

NOTE 2: BONDS DEFEASED IN PRIOR YEARS

During fiscal 1990, the Authority defeased the 1977 Series A Bonds, by placing a portion of the proceeds from the sale of the Hospital Revenue and Refunding Bonds, Series 1989, into an irrevocable trust to provide for all future debt service payments on the old bonds. During fiscal 1998, the Authority defeased the Series 1989 Bonds in the same manner. Accordingly, the trust account assets and the liability for the defeased bonds are excluded from the Authority's financial statements. During fiscal 2007 the remaining 1977 defeased bonds were paid, with no outstanding balance remaining. The Series 1989 Bonds were called during fiscal year 2000, with no outstanding balance remaining.

NOTE 3: BONDS PAYABLE

Petoskey Hospital Finance Authority Limited Obligation Revenue and Refunding Bonds, Series 1998, stated interest at 4.50% to 5.50%. (The effective interest rate for fiscal 2007 was 5.51% after inclusion of current amortization of bond issue costs, original issue discount and refunding deferral.)	$31,590,000
Petoskey Hospital Finance Authority Limited Obligation Revenue Bonds, Series 2003, interest at a variable rate of interest adjusted on the first day of each month, equal to 67% of the sum of 2% and the LIBOR rate. (The effective interest rate for fiscal 2007 was 5.00% after inclusion of current amortization of bond issue costs.)	9,538,080
Petoskey Hospital Finance Authority Limited Obligation Lease Revenue Bonds, Series 2006, interest fixed at 5.03%.	10,000,000
Total bonds payable	$51,128,080

Annual debt service requirements for the bonds are as follows:

Year ending June 30	Principal	Interest	Total
2008	$ 2,164,354	$ 2,510,611	$ 4,674,965
2009	2,955,351	2,375,802	5,331,153
2010	3,109,069	2,217,921	5,326,990
2011	3,277,336	2,057,101	5,334,437
2012	3,435,385	1,892,774	5,328,159
2013-2017	13,909,771	6,998,860	20,908,631
2018-2022	11,285,973	4,051,461	15,337,434
2023-2027	9,390,841	1,517,999	10,908,840
2028	1,600,000	40,000	1,640,000
Totals	$ 51,128,080	$ 23,662,529	$ 74,790,609

Series 1998 Bonds

Petoskey Hospital Finance Authority Limited Obligation Revenue and Refunding Bonds (Northern Michigan Hospitals Obligated Group) Series 1998 are serial and term bonds maturing in ascending amounts on November 15 of each year through 2012 and then on November 15, 2018 and November 15, 2027. Interest payments are due May 15 and November 15 each year until maturity.

Under terms of the Loan Agreement between the Authority and Northern Michigan Hospitals, Inc., the Hospital has agreed to pay to the Trustee at specified times amounts adequate to pay all debt service costs associated with the bond issue.

The Hospital has agreed to make such payments from its income available for debt service. Such income generally includes the excess of revenue, including investment income and gifts not restricted by donors, over expenses, excluding depreciation, amortization, interest expense and certain extraordinary items. In addition, the Hospital has agreed to maintain its tax exempt status, maintain a ratio of income available for debt service to the annual maximum debt service requirement of at least 1.5 to 1, and to maintain a "cushion ratio" of at least 2 to 1.

NOTE 3: BONDS PAYABLE – CONTINUED

The "cushion ratio" is determined as the sum of all unrestricted and unencumbered/unpledged cash and liquid investments whether classified as current or non-current assets (including board-designated funds, but excluding self-insurance funds) held by the Hospital for various purposes, divided by the maximum annual debt service on all outstanding indebtedness that is not secured by a fully funded Debt Service Reserve Fund.

At June 30, 2007, the Hospital was in compliance with these requirements.

The revenue bonds are not a general obligation of Petoskey Hospital Finance Authority. Further, they are not a debt of the City of Petoskey, Michigan, nor has the City pledged its faith and credit for payment of the bonds.

Bonds maturing through November 15, 2007 are not subject to early redemption except in extraordinary situations as defined in the agreement. Bonds maturing on or after November 15, 2008 are subject to early redemption on or after May 15, 2008 at the option of the Authority in whole or in part at any time at a premium descending from two percent of face value for any early redemptions made prior to May 15, 2010. Any early redemptions made on or after May 15, 2010 are to be at par. Accrued interest is due on any early redemption.

Bonds maturing on November 15, 2018 and November 15, 2027 are subject to mandatory redemption commencing November 15, 2013 and November 15, 2019 each year at specified amounts but without an early redemption premium. Annual redemptions ascend from $1,570,000 on November 15, 2013 to $2,105,000 on November 15, 2019 and then from $1,135,000 on November 15, 2020 to $1,600,000 on November 15, 2027.

An insurance policy is in force which unconditionally and irrevocably guarantees the full and complete payment required to be made by or on behalf of the Authority.

<u>Series 2003 Bonds</u>

Petoskey Hospital Finance Authority Limited Obligation Revenue Bonds Series 2003 (Northern Michigan Hospitals Obligated Group) are payable to Fifth Third Bank, the bondholder, together with interest, at a tax exempt interest rate, which is a variable rate of interest adjusted on the first day of each month equal to 67% of the sum of 2% and the LIBOR rate. The monthly payment amount will consist of principal and interest, sufficient to amortize the unpaid principal of the bonds over a 20-year amortization period, which began in December 2005.

Under terms of the Loan Agreement between the Authority and Northern Michigan Hospitals, Inc., the Hospital has agreed to authorize the bondholder to automatically debit the Hospitals account for loan repayments due.

The Hospital has agreed to maintain its tax exempt status, and maintain a ratio of total liabilities to fund balances that does not exceed 1.75 to 1.00. Additionally, the Hospital has agreed to maintain a cash flow coverage ratio of not less than 1.50 to 1.00. The cash flow coverage ratio is defined as the sum of net income, depreciation, amortization and interest expense during the period to the sum of all principal and interest payments with respect to indebtedness that are due and payable during the period.

NOTE 3: BONDS PAYABLE – CONTINUED

At June 30, 2007, the Hospital was in compliance with these requirements.

The bonds are not a general obligation of the Petoskey Hospital Finance Authority. Further, they are not a debt of the City of Petoskey, Michigan, nor has the City pledged its faith and credit for payment of the bonds.

The bonds are subject to optional prepayment, in whole or in part, and without penalty or premium on any interest payment date at par plus accrued interest.

Both Northern Michigan Hospital Foundation and Northern Michigan Regional Health System, Inc. have signed guaranty agreements with Fifth Third Bank for the issuance of these bonds.

Series 2006 Bonds

Petoskey Hospital Finance Authority Limited Obligation Lease Revenue Bonds, Series 2006 (Northern Michigan Hospitals Obligated Group) are payable to Fifth Third Bank, the bondholder, together with interest, at a tax-exempt rate, which is a fixed rate of 5.03% on the 15th day of each month through and including December 15, 2012. The monthly payments of $41,917 are interest only through December 15, 2007. Beginning January 15, 2008, the monthly payments will increase to $152,117 and will include both principal and interest. On December 15, 2012 the balance of $2,652,117, which includes interest through that date, will be due.

Under terms of the Master Lease-Purchase Agreement and Related Assignment Agreement the Authority has assigned it's rights to rental payments and security interest in the Equipment from the Hospital to Fifth Third Bank as bondholder in satisfaction of amounts due under the terms of the Related Bond.

The Hospital has agreed to maintain its tax-exempt status and comply with the 2003 Loan Agreement financial covenants.

At June 30, 2007, the Hospital was in compliance with these requirements.

The bonds are not a general obligation of the Petoskey Hospital Finance Authority. Further, they are not a debt of the City of Petoskey, Michigan, nor has the City pledged its faith and credit for payment of the bonds.

The bonds are subject to early termination upon receipt of the Purchase Option Amount or the Recourse Deficiency Amount, as applicable, all in accordance with Article XI of the Master Lease-Purchase Agreement.

On December 20, 2006, the proceeds of the bond, $10,000,000, were placed into an escrow account, the Acquisition Fund with Fifth Third Bank as custodian for the benefit of the Hospital to be used to acquire equipment. At the end of the eighteenth month following that date any moneys remaining in the Acquisition Fund (including interest earned and gains and losses on investments of the moneys on deposit in the Acquisition Fund) shall be applied to amounts owed. As of November 30, 2007, there was $1,925,903 remaining in the Acquisition Fund.

NOTE 4: LOAN RECEIVABLE AND PAYMENTS TO DEFRAY BOND INTEREST EXPENSE

Payments required by the Hospital include both principal and interest. Only the portion of the payments attributed to principal is applied against the loan receivable. The portion of the payments attributed to interest is recorded as a payment to defray interest expense.

Payments for the Series 1998 bonds by the Hospital are due on or about May 1 each year for the interest payment due May 15 on the Bonds, with credit on the payment for any amount on deposit. Further, payments are due on or about November 1 each year for the principal and interest payment due November 15 on the Bonds, with credit on the November 1 payment for any amount on deposit.

Payments for the Series 2003 and Series 2006 bonds are due monthly. They are paid directly by the Hospital to the bondholder, Fifth Third Bank.

The Hospital has also agreed to pay all Trustee fees and all costs incurred by the Authority.